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1st Session

SENATE

REPORT
100-46

FIRST MONETARY POLICY REPORT FOR 1987

FROM THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

A REPORT

together with

ADDITIONAL VIEWS

SUBMITTED PURSUANT TO PUBLIC LAW 95-523

APRIL 28 (legislative day, APRIL 21), 1987.—Ordered to be printed

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LETTER OF TRANSMITTAL

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC, April 28, 1987.

Hon. GEORGE BUSH,
President of the U.S. Senate,
Washington, DC.

DEAR MR. PRESIDENT: Transmitted herewith is the First Monetary Policy Report for 1987 on the Conduct of Monetary Policy, pursuant to Public Law 95–523 and oversight hearings held on February 18 and 19, 1987.

Sincerely yours,

WILLIAM PROXMIRE, *Chairman.*

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Mr. PROXMIRE, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT

together with

ADDITIONAL VIEWS

[Submitted pursuant to Public Law 95–523]

FIRST MONETARY POLICY REPORT FOR 1987

Introduction

On February 18, 1987, the Committee on Banking, Housing, and Urban Affairs commenced the monetary policy hearings called for by the Full Employment and Balanced Growth Act of 1978. At the first hearing the testimony of five nationally recognized monetary policy experts of diverse perspectives was received and discussed by the Committee. The five witnesses were: Steven Axilrod, Vice Chairman, Nikko Securities, and formerly the Director of the Federal Reserve's Office of Monetary Policy; Lawrence Chimerine, Chairman, Chase Econometrics; H. Erich Heinemann, Chief Economist, Ladenburg Thalmann; Alan H. Meltzer, Carnegie Mellon University; and Paul Craig Roberts, Georgetown University. The following day, on Febuary 19th, the Committee received from the Federal Reserve the "Monetary Policy Report to Congress" and heard the testimony of its chairman, Paul A. Volcker, on the conduct of monetary policy during the second half of 1986 and the Federal Reserve's monetary policy objectives during 1987.

The testimony of the Federal Reserve chairman and that of the private and academic sector monetary policy experts provided the Committee with an ample body of information on which to base the Committee's findings and recommendations. These findings and recommendations, in contrast with the Committee's monetary policy reports in years past, deal principally with international eco-

nomic interdependence and cooperation. This is the result, perhaps not surprising, of the strong relationships known to exist among the U.S. fiscal and trade deficits, the rates of exchange between the dollar and other industrialized-nation currencies, the degree of monetary and fiscal expansion in the other industrialized nations, the persistent misalignment of the exchange rates between the dollar and the currencies of newly industrialized nations, the sensitivity of the debt burden on the less developed nations to U.S. interest rates, and the dependency of U.S. interest rates on the actions of other nations.

The Committee's findings and recommendations are herewith transmitted to the Senate for its consideration and use.

FINDINGS AND RECOMMENDATIONS

1. The Committee finds that the Federal Reserve's intended monetary policy actions for 1987 as reported to the Committee to be acceptable in the context of current domestic and international economic conditions.

RANGES OF GROWTH FOR MONETARY AND DEBT AGGREGATES

[Percent change, fourth quarter to fourth quarter]

	1987	1986
M2	5½ to 8½	6 to 9
M3	5½ to 8½	6 to 9
Debt	8 to 11	8 to 11

A number of conflicting factors, including the enormous U.S. budget deficit, the need to continue to attract funds from overseas, the magnitude of the amounts of poorly performing domestic and developing-nation debt, the potential for increased inflation, and a sluggish economy, have combined to severely hamper the Federal Reserve's flexibility in conducting monetary policy. In this context, the Federal Open Market Committee's decision to reduce somewhat the growth rates of the money supply measures, shown above, to achieve noninflationary growth and external equilibrium appears to be entirely appropriate.

2. The Committee finds that there is a need to shift U.S. economic priorities away from consumption and into investment in order to reverse the present trade imbalance and ensure longer-term economic stability.

The level of GNP in 1982 dollars reached $3.7 trillion last year. This is the total of all output in the United States in 1986, and it was up about 2.1 percent from the year before. Too much of that spending was for private and public consumption, and was financed with increases in debt—corporate debt, household debt, and, of course, government debt—much of it borrowed from abroad. If the international trade imbalance is to be rectified, a major shift in economic priorities within the United States away from consumption and into investment must take place. On this point there was virtual unanimity among the witnesses that appeared before the Committee.

Professor Alan Meltzer expressed the problem most succinctly:

> Our problem is that we are not producing domestically the goods to satisfy [domestic] demand. We are importing them from abroad. Consequently, we have a large trade imbalance. Our problem is that we are spending most of the money that we are borrowing for consumption, not for investment. If we were spending it for investment, we would have the resources in the future to retire the debt that we have put out and to service that debt. Because we spend it for consumption, we live better now at the enpense of the future.

The Committee is particularly concerned about one of the major implications of such a shift in priorities—a downward shift in U.S. living standards. For the past four years or so, spending in this country has grown annually about 1¼ percent more than output. If we are to reduce our dependence on imported goods and reverse our trade balance, the relationship between domestic spending and output must also be reversed. A reduction in the growth of consumption spending will impact virtually every sector of the U.S. economy. And to the extent living standards are measured in consumption terms, there must necessarily be a reduction in the rate of improvement, at least in the medium term. Over the long term, however, because the present mix of U.S. spending and investment cannot be sustained, our future living standards will be higher only if we shift toward more investment.

There is considerable uncertainty as to just how much investment should be increased in relation to total spending and over what time period it should take place. In response to a question on this matter, Mr. Steven Axilrod estimated the likely magnitude of the adjustment in the following way:

> . . . depending on how fast an adjustment you want to make, [spending] can grow, say a half a point to one point less [than output] for several years or two or three points less for a couple of years, or we could back ourselves into a sharp recession and get the whole thing over with very promptly. But that is what we are confronted with.

Managing the shift in U.S. resource allocation from consumption to investment, in the judgment of the Committee, will be possibly the most challenging aspect of U.S. economic policymaking over the next decade. Success in this regard will require not only the best efforts of U.S. policymakers; it will also require unprecedented cooperation and economic coordination among the industrialized nations.

3. The Committee finds that the present degree of monetary and fiscal policy coordination between the United States and its two key trading partners, Japan and West Germany, is insufficient to assure economic stability and growth internationally. The Committee urges the Federal Reserve and the Administration to use every appropriate means to induce Japan and West Germany to adopt more expansive monetary policy and, particularly, much more stimulative fiscal policies.

The major industrialized nations abroad, principally Japan and West Germany, have depended on strong net export growth rather

than domestic demand to expand their economies in recent years. The strength of the dollar, an improved technological base, and relatively low labor costs abroad have enabled these nations to rely on net export growth to the extent they have. Our trading partners must now make adjustments in their monetary and fiscal policies that offset the contractionary adjustments needed in U.S. macroeconomic policies.

The decline in the dollar over the past two years has decreased the competitive position of foreign nations significantly. As their trade surpluses decline, they will have to rely more heavily on the expansion of domestic demand to maintain economic growth. Japan in particular must allocate less of its resources to export industries and more to those industries satisfying domestic demand needs. The United States at the same time must attempt to do precisely the reverse.

The United States must reduce its budget deficit to free up resources for export production. Failure to rein in the U.S. budget deficit while at the same time trying to expand exports increases the threat of domestic inflation or a rise in interest rates that would cripple investment. In the other nations, more expansionary monetary and fiscal policies are needed to avoid the pain of recession and unemployment as those nations reallocate resources away from export sectors and into sectors producing to meet domestic demand.

4. The Committee finds the present degree of disclosure by the Administration and Federal Reserve regarding the levels of GNP growth that our major trading partners must attain to maintain international economic stability, is inadequate.

The Committee believes that a strong spirit of cooperation and joint effort will be necessary if the leading industrialized nations are to be successful in achieving mutually beneficial adjustments in their economies. To secure such a spirit of cooperation, the Committee recomends that the macroeconomic and exchange rate adjustments that the major industrialized nations, in particular, Japan, West Germany, and the U.S., need to make in order to stabilize international trade and financial flows, be disclosed to the full extent that they are known.

It is well understood that the present mix of international trade and financial flows is unbalanced and over the longer term, unstable. It is also understood by this Committee that significant adjustments in U.S. economic priorities are needed, and at least in terms of the U.S. budget deficit, some of those needed adjustments are underway. All the adjustments will involve some sacrifice on the part of U.S. citizens. For U.S. efforts to be successful, compensating adjustments in the monetary and fiscal policies of our major trading partners are also needed. This much is clear.

What is not clear is how large those adjustments must be and whether our trading partners, particularly Japan and West Germany, are willing or able to make the needed adjustments. In this regard, the Committee was disappointed that Federal Reserve Chairman Volcker did not respond more specifically to a question from Senator Riegle on this issue.

> Senator RIEGLE. * * * it seems to me the economies of those other nations have to grow, and I'm wondering what

> kind of growth rates you and Secretary Baker might have in mind.
>
> For example, West Germany, would we be thinking of maybe a growth rate of 3 or 4 percent, something in that range; and with respect to Japan, are we thinking about something like 4 or 5 percent? Where are we in terms of what it takes to make the system balance here?
>
> Mr. VOLCKER. Well, those growth rates would be very nice, but I don't want to set out a particular target. * * *

In the future and in light of the kinds of changes that have to take place in the U.S. economy, this kind of response from the head of the U.S. central bank or from the head of one of our executive branch agencies will not be acceptable. It is imperative that the leadership of the Federal Reserve and the Administration confer with their counterparts in the governments of the other leading industrialized nations, determine what kinds and amounts of adjustments are needed, and disclose those targets. Only by such a process can the energies and commitment be marshalled within our own nation to make needed changes. Similarly, in the Committee's judgment, such disclosure is essential if the other industrialized democracies, particularly Japan and West Germany, are to succeed in marshalling efforts within their own nations.

5. The Committee finds that the United States should not continue to rely on monetary and fiscal policies as expansionary as the present ones are. Instead, the U.S. budget deficit should continue to be reduced freeing up resources for export industry expansion and the growth of the monetary aggregates should be reduced to more historically comparable levels.

The necessity for the Federal Reserve to monetize the deficit has left it in a situation in which it can hold down short-term interest rates and promote capital formation, only at the cost of a progressive acceleration in money growth. The essential long-term solution to this predicament is to reduce the U.S. budget deficit. The consequences to the U.S. economy of continuing the present policies, particularly the current monetary policy, was made clear by Senator William Proxmire, Chairman of the Committee, in his opening statement:

> This Senator is concerned that the rapid growth of monetary reserves exceeds prudence. This growth is unwise in the view of the inflation potential residing in dollar exchange rate declines, energy price increases and federal spending imbalances. Realization of this potential accompanied with continued rapid money growth can have over time only one sure result—inflation—the result of too much money chasing too few goods. In an economy as debt burdened as our own is, the further consequence of an uptrend in inflation will be a skyrocketing of interest rates, followed by a sharp economic slowdown, and rapidly increasing employment.

Federal Reserve Chairman Volcker in a related discussion with Chairman Proxmire confirmed these concerns. Referring to his prepared statement, Chairman Volcker warned the Committee of the

Federal Reserve's likely reaction to an unacceptable uptrend in inflationary growth. The portion of his statement referred to reads:

> I would point out that the sensitivity of M1 to interest rates and other developments will not always work in the direction of relatively high growth. To the contrary, action to reduce the rate of M1 growth, promptly and substantially, would be called for in a context of strongly rising economic activity and signs of emerging and potential price pressures, perhaps related to significant weakness of the dollar externally.

It is precisely this situation—a precipitous contraction in the money supply and its attendant interest rate effects—that the Committee would like to see avoided.

ADDITIONAL VIEWS OF SENATOR WILLIAM PROXMIRE

By almost any measure, monetary policy was far too accommodative in 1986. If the Federal Reserve persists in its loose money policy, the inevitable result will be a resurgence of inflation followed by a sharp recession. Should this occur, the credibility of the Federal Reserve as an agent of economic stability will have been squandered away. Thus the stakes in a sound monetary policy are enormously high.

The rate of money growth in 1986, as measured by M–1, was 15 percent, almost double the FED's upper target range of 8 percent and more than triple the growth of nominal GNP. Some argue that M–1 is no longer a useful guide to monetary policy because the public is more willing to hold savings balances in interest bearing transactions accounts as a result of lower interest rates. But much of this argument is circular in nature. Interest rates declined throughout 1986 in part because the FED opened up the monetary flood-gates.

Other indicators of money growth showed the same excessive growth pattern. The rate of increase in M–2 and M–3 were both near 9 percent, more than twice the increase in GNP. Total debt grew by 13 percent, well over the FED's upper target of 11 percent.

Primarily because of the FED's generous money growth policy, interest rates were driven down to new lows. The short term T-bill rate fell by one and a half percentage points. The long term corporate bond rate fell by nearly two and a half percentage points. Home mortgage rates declined by over one percentage point.

Under normal circumstances, lower interest rates spell good news for the economy. But the lower rates of today are not due to any permanent improvement in the public's rate of saving. Indeed, savings rates have declined to all time lows. Instead, lower interest rates have been brought about primarily by the FED's overly expansive monetary policy. These lower interest rates cannot be indefinitely sustained by further monetary expansion. Our economy is literally living on borrowed time.

For the time being however, the lower interest rates engineered by the FED have managed to keep the recovery going for another 12 months. Lower interest rates have induced a record level of consumer borrowing while at the same time they discouraged consumer saving. Consumer debt grew by over 10 percent in 1986 while the consumer savings rate declined to less than 3 percent—an all time low.

The record level of consumer borrowing has allowed consumption spending to increase by 4 percent in real terms while residential construction expenditures rose by over 9 percent. With other sectors lagging, the total economy grew by 2.5 percent in real terms. Where it not for the expansive monetary policy of the FED, real growth could have been considerably lower.

No doubt, many would conclude the FED's policy has been successful in maintaining growth and avoiding an economic downturn. While an economic growth rate of 2.5 percent for 1986 was not exactly something to shout about, the FED's policy has at least allowed us to enter the fifth year of our current recovery, which is a year or two longer than the post war average recovery.

But how sustainable is an economy driven by debt financed consumption? Sooner or later, households will exhaust their capacity for new debt. Indeed, consumer debt burdens have already reached an all time high. Once the consumer debt bubble is burst, consumer expenditures will decline sharply with ripple effects throughout the entire economy. The recession the FED tried to avoid in 1986 will simply be postponed, but in the end it will be longer and more severe.

Whatever monetary growth targets the FED may report to Congress, by now it should be clear that the FED in fact, is targeting the growth of real GNP. Whenever the growth of real GNP threatens to decline, the FED steps on the monetary accelerator. Whenever the rate of real growth becomes "too high" in the judgment of the FED, it steps on the monetary brakes.

There is a name for this policy. It is called finetuning. It is substantially the same discredited policy followed by the FED throughout most of the 1960's and 70's. Its legacy is rampant inflation, sky-high interest rates and stagnant growth.

With the influence of supply-side economists on the Board, the FED is in danger of falling into the same trap that befell the Keynesian liberals a decade or two ago. The common error is the notion that economic policy can be used to repeal the business cycle—that economists are smart enough to anticipate all of the dynamic movements in a complex market economy and design policies to raise the level of real growth over the course of many business cycles.

As history has shown, attempting to fine tune the economy through fiscal or monetary policy just doesn't work. The economics profession promises far more than it has been able to deliver. In the end, the actions of the monetary and fiscal authorities have proven to be more de-stabilizing than stabilizing.

That is why the FED's policies for 1986 and 1987 are of profound concern to our economic well-being. If the FED continues on its present course of attempting to prevent a recession through excessive money growth, the inevitable result will be more inflation and less growth.

ADDITIONAL VIEWS OF MESSRS. GARN, HECHT, AND GRAMM

New challenges always will continue arising to confront policymakers in a dynamic economy like the United States'; but in focusing on today's problems, sight should not be lost of the impressive economic accomplishments of recent years. The U.S. currently is enjoying its 53rd consecutive month of economic growth, and in October, the present economic expansion will become the longest peacetime expansion in the postwar era.

During each of the last five years, the inflation rate has remained at or below four percent, less than one-third the rate prevailing in 1980. Since this economic expansion began, more than 13 million new payroll jobs have been created; the unemployment rate has fallen by four percentage points. The share of the working age population with jobs is at an all-time high.

BUDGET DEFICIT

The Federal Budget deficit, which equalled 5.3 percent of gross national product (GNP) last year, is the most urgent economic challenge facing policymakers today. In addressing the deficit, Congress must recognize that it is the product of runaway spending, not of a falloff in tax revenues: Compared to fiscal 1978, the 1986 Federal expenditure share of GNP was 2.7 percentage points higher while the revenue share of GNP was virtually the same.

Reducing the budget deficit through expenditure restraint is the key to solving a second major challenge facing policymakers, the trade deficit. Persistent budget deficits during a period of sustained economic expansion have created a shortfall of domestic savings within the U.S. The resultant capital inflow from abroad led to a dollar-for-dollar increase in the current account deficit.

Protectionist trade legislation and efforts to further depress the value of the dollar have been suggested as alternative policy initiatives to combat the trade deficit, but either of these policy prescriptions would pose unacceptable risks to the U.S. economy. Protectionist trade legislation would invite retaliatory measures abroad and threaten a trade war that would abort the economic expansion. Further efforts to depress the dollar would risk a free-fall and domestic inflationary pressures that would require sharply higher interest rates to stop.

Neither protectionist trade legislation nor further efforts to push down the dollar's value should be used to avoid the tough decisions needed to cut the budget deficit and, thereby, come to grips with the real culprit behind the trade deficit. Reducing the budget deficit also would strengthen the hand of U.S. negotiators in seeking additional economic stimulus and a lowering of trade barriers in

Japan and Western Europe, two additional steps that would provide significant help toward reducing the U.S. trade deficit.

MONETARY POLICY

Regardless of whether recent money growth has been too rapid, few would doubt that monetary policy eventually will need to be tightened. Historical evidence leaves little doubt that persistent money growth at recent rates eventually would lead to an unacceptable rise in the inflation rate.

When monetary policy is tightened and should interest rates rise, pressures will increase on the depository institutions through which monetary policy is implemented. Fixed-rate mortgage lenders, of course, will be the hardest hit, but all depositories will suffer as spreads narrow and borrowers, who must make large cash payments to service their debts, decline in creditworthiness.

Congress has a responsibility to take the steps necessary to assure that the nation's depository system has the strength and resources to cope with the tightening of monetary policy that will inevitably be needed. Failure by Congress to take these steps in a timely fashion could severely constrain the flexibility needed by the Federal Reserve to implement monetary policy in a manner consistent with the broad national interest.

Almost a full year has now elapsed since the Administration asked Congress to approve borrowings of up to $15 billion as part of a plan to provide the Federal Savings and Loan Insurance Corporation (FSLIC) with $25 to $32.5 billion over five to seven years. Congress' own General Accounting Office has attested to the need for the borrowing authority. While both Houses of Congress approved FSLIC recapitalization in 1986, final Congressional approval was never attained because the issue became intertwined with other more controversial issues.

Congress has an obligation to the American people to stop delaying final approval for FSLIC recapitalization. Congress also has a responsibility to prevent a weakening of the nation's depositories by archaic laws that prevent depositories from responding to the rapid, ongoing changes in the financial services marketplace.

Commercial banks have seen their traditional role in the provision of credit to state and local governments undermined by the growing use of revenue bonds and their traditional role in the provision of credit to better-rated business borrowers undermined by commercial paper. Both banks and thrifts are seeing their traditional role in the provision of credit to homebuyers undermined by mortgage-backed securities.

Unless Congress allows depository institutions to respond to innovations that are securitizing more and more of their traditional loan products, depository institutions will continue to be weakened. Depository institutions also are being challenged competitively by diversified providers of financial services that can cross-market a far broader array of services to consumers of financial products.

Failure by Congress to amend the laws that are preventing depository institutions from responding to the competitive challenge from securitization and the new diversified providers of financial services will weaken the nation's depository institutions. This, in

turn, will constrain the ability of the Federal Reserve to tighten monetary policy when necessary for fear that the nation's weakened depositories cannot withstand the associated strains.

CONCLUSIONS

Reducing the Federal budget deficit through expenditure restraint is the macroeconomic policy action most urgently needed at the present time. Reducing the budget deficit is essential to lowering the trade deficit. Protectionist trade legislation and further declines in the value of the dollar should not be used as alternatives to coming to grips with the budget deficit.

Congress has responsibilities in the realm of monetary policy that go beyond merely exercising oversight over the actions of the Federal Reserve. Foremost among those responsibilities is to assure that the nation's depository institutions remain healthy and viable financial intermediaries, for it is through the nation's depository institutions that monetary policy is implemented.

The strength of the nation's depository institutions is most critical at times like the present when firming interest rates and the inevitable need to eventually slow the growth in the monetary aggregates guarantee rising pressures on depository institutions. Before criticizing the Federal Reserve for failing to take particular monetary policy actions, Congress should first take the legislative steps needed to strengthen the nation's depository institutions and, thereby, give the Federal Reserve the flexibility to conduct monetary policy in the broad national interest.

Today, Congress has two urgent obligations. One, Congress should stop delaying action on FSLIC recapitalization. Two, Congress must do away with legislative impediments, both new and old, that undermine the health and vitality of the nation's depository institutions by preventing them from responding to the ongoing changes in the financial services industry.

JAKE GARN.
CHIC HECHT.
PHIL GRAMM.

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